

HANDLEMAN CO /MI/  
Form 10-Q  
December 16, 2003  
Table of Contents

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## Form 10-Q

### QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the second quarter ended November 1, 2003

Commission File Number 1-7923

## Handleman Company

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(Exact name of registrant as specified in its charter)

Michigan  
(State or other jurisdiction of

incorporation or organization)

38-1242806  
(I.R.S. Employer Identification No.)

500 Kirts Boulevard, Troy, Michigan  
(Address of principal executive offices)

48084-4142  
(Zip code)

Area Code 248 362-4400  
(Registrant's telephone number)

Indicate by checkmark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. YES  NO

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Indicate by checkmark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). YES  NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <u>CLASS</u>                   | <u>DATE</u>      | <u>SHARES OUTSTANDING</u> |
|--------------------------------|------------------|---------------------------|
| Common Stock - \$.01 Par Value | December 5, 2003 | 24,446,960                |

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**Table of Contents**

HANDLEMAN COMPANY

INDEX

|  | <b><u>PAGE NUMBER(S)</u></b> |
|--|------------------------------|
| <b>PART I - FINANCIAL INFORMATION</b>  |                              |
| Item 1. Financial Statements   |                              |
| <u>Consolidated Statements of Income</u>   | 1                            |
| <u>Consolidated Balance Sheets</u>   | 2                            |
| <u>Consolidated Statement of Shareholders' Equity</u>  | 3                            |
| <u>Consolidated Statements of Cash Flows</u>   | 4                            |
| <u>Notes to Consolidated Financial Statements</u>  | 5 - 13                       |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 - 18                      |
| Item 4. <u>Controls and Procedures</u>   | 19                           |
| <b>PART II - OTHER INFORMATION</b>   |                              |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u>                                   | 20                           |
| Item 6. <u>Exhibits and Reports on Form 8-K</u>  | 20                           |
| <u>SIGNATURES</u>  | 21                           |

**Table of Contents**

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## HANDLEMAN COMPANY

## CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(in thousands of dollars except per share data)

|  | Three Months     |             | Six Months       |             |
|--|------------------|-------------|------------------|-------------|
|  | (13 Weeks) Ended |             | (26 Weeks) Ended |             |
|  | October 26,      | October 26, | October 26,      | October 26, |
|  | November 1,      | November 1, | November 1,      | November 1, |
|  | 2003             | 2002        | 2003             | 2002        |
|  |                  | (Restated)  |                  | (Restated)  |
| Revenues   | \$ 269,900       | \$ 303,159  | \$ 475,193       | \$ 567,915  |
| Costs and expenses:  |                  |             |                  |             |
| Direct product costs   | 214,548          | 236,097     | 375,633          | 447,047     |
| Selling, general and administrative expenses   | 43,050           | 50,019      | 85,315           | 99,636      |
| Interest (income) expense, net   | 219              | 54          | (7)              | 252         |
| Income from continuing operations before income taxes and minority interest  | 12,083           | 16,989      | 14,252           | 20,980      |
| Income tax expense   | (3,552)          | (5,758)     | (4,958)          | (7,444)     |
| Minority interest  |                  | 192         |                  | 366         |
| Income from continuing operations  | 8,531            | 11,423      | 9,294            | 13,902      |
| Discontinued operations (Note 2):  |                  |             |                  |             |
| Income from operations of discontinued subsidiary companies (including loss on disposal of \$665 for the three months and six months ended November 1, 2003) | 3,779            | 3,746       | 5,341            | 4,019       |
| Income tax expense   | (2,128)          | (1,424)     | (2,743)          | (1,515)     |
| Income from discontinued operations  | 1,651            | 2,322       | 2,598            | 2,504       |
| Net income   | \$ 10,182        | \$ 13,745   | \$ 11,892        | \$ 16,406   |
| Income per share:  |                  |             |                  |             |
| Continuing operations - basic  | \$ 0.34          | \$ 0.43     | \$ 0.37          | \$ 0.53     |

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|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Continuing operations - diluted                                 | \$ 0.34 | \$ 0.43 | \$ 0.37 | \$ 0.53 |
| Discontinued operations - basic                                 | \$ 0.07 | \$ 0.09 | \$ 0.11 | \$ 0.09 |
| Discontinued operations - diluted                               | \$ 0.07 | \$ 0.09 | \$ 0.10 | \$ 0.09 |
| Net income - basic  | \$ 0.41 | \$ 0.52 | \$ 0.48 | \$ 0.62 |
| Net income - diluted  | \$ 0.41 | \$ 0.52 | \$ 0.47 | \$ 0.62 |
| Weighted average number of shares outstanding during the period |         |         |         |         |
| Basic   | 24,742  | 26,202  | 25,034  | 26,339  |
| Diluted   | 24,952  | 26,217  | 25,212  | 26,361  |

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents**

## HANDLEMAN COMPANY

## CONSOLIDATED BALANCE SHEETS

(in thousands of dollars except share data)

|  | November 1,<br>2003<br>(Unaudited) | May 3,<br>2003    |
|--|------------------------------------|-------------------|
|  | <u>          </u>                  | <u>          </u> |
| <b>ASSETS</b>  |                                    |                   |
| Current assets:  |                                    |                   |
| Cash and cash equivalents  | \$ 27,177                          | \$ 62,698         |
| Accounts receivable, less allowances of \$11,742 at November 1, 2003 and \$24,269 at May 3, 2003 | 214,496                            | 201,994           |
| Merchandise inventories  | 176,597                            | 119,979           |
| Other current assets   | 13,866                             | 17,993            |
| Assets held for sale   | 73,031                             |                   |
|  | <u>          </u>                  | <u>          </u> |
| Total current assets   | 505,167                            | 402,664           |
|  | <u>          </u>                  | <u>          </u> |
| Property and equipment:  |                                    |                   |
| Land, buildings and improvements   | 13,737                             | 13,917            |
| Display fixtures   | 33,993                             | 32,876            |
| Computer hardware and software   | 39,263                             | 35,195            |
| Equipment, furniture and other   | 34,111                             | 33,073            |
|  | <u>          </u>                  | <u>          </u> |
|  | 121,104                            | 115,061           |
| Less accumulated depreciation  | 65,941                             | 59,328            |
|  | <u>          </u>                  | <u>          </u> |
|  | 55,163                             | 55,733            |
|  | <u>          </u>                  | <u>          </u> |
| Goodwill, net  | 3,406                              | 3,406             |
| Intangible assets, net   |                                    | 44,715            |
| Other assets, net  | 22,647                             | 19,046            |
|  | <u>          </u>                  | <u>          </u> |
| Total assets   | \$ 586,383                         | \$ 525,564        |
|  | <u>          </u>                  | <u>          </u> |
| <b>LIABILITIES</b>   |                                    |                   |
| Current liabilities:   |                                    |                   |
| Accounts payable   | \$ 227,826                         | \$ 159,747        |
| Debt, current portion  |                                    | 3,571             |
| Accrued and other liabilities  | 30,449                             | 40,630            |
| Liabilities held for sale  | 13,141                             |                   |
|  | <u>          </u>                  | <u>          </u> |
| Total current liabilities  | 271,416                            | 203,948           |
|  | <u>          </u>                  | <u>          </u> |
| Debt, non-current  |                                    | 3,571             |
| Other liabilities  | 9,726                              | 9,199             |

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SHAREHOLDERS EQUITY

Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued

Common stock, \$.01 par value; 60,000,000 shares authorized;

|   |                   |                   |
|---|-------------------|-------------------|
| 24,496,000 and 25,659,000 shares issued at November 1, 2003 and May 3, 2003, respectively | 245               | 257               |
| Accumulated other comprehensive loss  | (521)             | (4,716)           |
| Unearned compensation   | (7,554)           | (3,141)           |
| Retained earnings   | 313,071           | 316,446           |
|   | <u>305,241</u>    | <u>308,846</u>    |
| Total shareholders equity   | 305,241           | 308,846           |
|   | <u>\$ 586,383</u> | <u>\$ 525,564</u> |
| Total liabilities and shareholders equity   | \$ 586,383        | \$ 525,564        |

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents**

## HANDLEMAN COMPANY

## CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(UNAUDITED)

(in thousands of dollars)

Six Months (26 Weeks) Ended November 1, 2003

|   | Common Stock  |        | Other Comprehensive Income (Loss)       |                           |            | Unearned Compensation | Retained Earnings | Total Shareholders' Equity |
|---|---------------|--------|---|---------------------------|------------|-----------------------|-------------------|----------------------------|
|   | Shares Issued | Amount | Foreign Currency Translation Adjustment | Minimum Pension Liability |            |                       |                   |                            |
| May 3, 2003   | 25,659        | \$ 257 | \$ (591)                                | \$ (4,125)                | \$ (3,141) | \$ 316,446            | \$ 308,846        |                            |
| Net income  |               |        |   |                           |            | 11,892                | 11,892            |                            |
| Adjustment for foreign currency translation   |               |        | 4,195                                   |                           |            |                       | 4,195             |                            |
| Comprehensive income, net of tax  |               |        |   |                           |            |                       | 16,087            |                            |
| Cash dividends, \$.07 per share   |               |        |   |                           |            | (1,735)               | (1,735)           |                            |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 181           | 1      |   |                           | (4,413)    | 8,646                 | 4,234             |                            |
| Common stock repurchased  | (1,344)       | (13)   |   |                           |            | (22,532)              | (22,545)          |                            |
| Tax benefit from exercise of stock options  |               |        |   |                           |            | 354                   | 354               |                            |
| November 1, 2003  | 24,496        | \$ 245 | \$ 3,604                                | \$ (4,125)                | \$ (7,554) | \$ 313,071            | \$ 305,241        |                            |

The accompanying notes are an integral part of the consolidated financial statements.



**Table of Contents**

## HANDLEMAN COMPANY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(in thousands of dollars)

|  | Six Months        |                   |
|--|-------------------|-------------------|
|  | (26 Weeks) Ended  |                   |
|  | November 1,       | October 26,       |
|  | 2003              | 2002              |
|  | <u>          </u> | <u>(Restated)</u> |
| <b>Cash flows from operating activities:</b>   |                   |                   |
| Net income   | \$ 11,892         | \$ 16,406         |
| <b>Adjustments to reconcile net income to net cash provided from operating activities:</b> |                   |                   |
| Depreciation   | 7,060             | 9,716             |
| Amortization of acquisition costs  |                   | 135               |
| Recoupment/amortization of acquired rights   | 9,417             | 11,573            |
| Loss (gain) on disposal of property and equipment  | 160               | (63)              |
| Impairment of subsidiary assets  | 665               |                   |
| Tax benefit from exercise of stock options   | 354               | 350               |
| <b>Changes in operating assets and liabilities:</b>  |                   |                   |
| Increase in accounts receivable  | (33,846)          | (13,238)          |
| Increase in merchandise inventories  | (67,178)          | (66,527)          |
| Decrease in other operating assets   | 1,753             | 9,639             |
| Increase in accounts payable   | 74,918            | 58,706            |
| Decrease in other operating liabilities  | (4,724)           | (10,809)          |
| <b>Total adjustments</b>   | <u>(11,421)</u>   | <u>(518)</u>      |
| <b>Net cash provided from operating activities</b>   | <u>471</u>        | <u>15,888</u>     |
| <b>Cash flows from investing activities:</b>   |                   |                   |
| Additions to property and equipment  | (6,716)           | (7,157)           |
| Proceeds from disposition of properties and equipment                                      | 240               | 4,738             |
| Acquired rights  | (6,522)           | (10,035)          |
| Additional investments in subsidiary companies   |                   | (5,840)           |
| <b>Net cash used by investing activities</b>   | <u>(12,998)</u>   | <u>(18,294)</u>   |
| <b>Cash flows from financing activities:</b>   |                   |                   |
| Cash dividends   | (1,735)           |                   |
| Issuances of debt  | 12,075            | 1,498,508         |
| Repayments of debt   | (19,218)          | (1,505,994)       |
| Repurchase of common stock   | (22,545)          | (6,993)           |

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|  |                   |                   |
|--|-------------------|-------------------|
| Other changes in shareholders' equity, net       | 8,429             | 3,529             |
|  | <u>          </u> | <u>          </u> |
| Net cash used by financing activities            | (22,994)          | (10,950)          |
|  | <u>          </u> | <u>          </u> |
| Net decrease in cash and cash equivalents        | (35,521)          | (13,356)          |
| Cash and cash equivalents at beginning of period | 62,698            | 20,254            |
|  | <u>          </u> | <u>          </u> |
| Cash and cash equivalents at end of period       | \$ 27,177         | \$ 6,898          |
|  | <u>          </u> | <u>          </u> |

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies

In the opinion of management, the accompanying Consolidated Balance Sheets and Consolidated Statements of Income, Shareholders' Equity and Cash Flows contain all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position of the Company as of November 1, 2003, and the results of operations and changes in cash flows for the six months then ended. Because of the seasonal nature of the Company's business, sales and earnings results for the six months ended November 1, 2003 are not necessarily indicative of what the results will be for the full year. The Consolidated Balance Sheet as of May 3, 2003 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended May 3, 2003, including the discussion of the Company's critical accounting policies.

2. Discontinued Operations

During the second quarter ended November 1, 2003, the Company committed to a plan, and reached an agreement, to sell certain of its subsidiary companies (generally known as Anchor Bay Entertainment) within its North Coast Entertainment (NCE) business segment. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the financial results of these subsidiary companies to be sold were reported separately as discontinued operations in the Company's Consolidated Statements of Income for all periods presented, since the operations and cash flows of these companies will be eliminated from the ongoing operations of the Company upon completion of the sale. The Company will not have any continuing involvement in the operations of these companies after the disposal transaction. Under the provisions of SFAS No. 144, the Company recorded a pre-tax impairment charge of \$665,000 (\$1,057,000 after tax), which is included in Income from discontinued operations in the Company's Consolidated Statements of Income. The sale was completed on December 11, 2003 and generated approximately \$60,000,000 in cash.

In accordance with SFAS No. 144, the assets and liabilities related to the sale of the subsidiary companies have been classified as held for sale in the Company's Consolidated Balance Sheet as of November 1, 2003. The table below summarizes the major categories of assets and liabilities held for sale at November 1, 2003 (in thousands of dollars):

|                                  |           |
|----------------------------------|-----------|
| <u>Assets held for sale</u>      |           |
| Accounts receivable              | \$ 21,545 |
| Merchandise inventories          | 10,560    |
| Acquired rights                  | 39,717    |
| Property and equipment, net      | 210       |
| All other operating assets       | 999       |
|                                  | <hr/>     |
| Total assets held for sale       | \$ 73,031 |
|                                  | <hr/>     |
| <u>Liabilities held for sale</u> |           |
| Accounts payable                 | \$ 6,839  |
| All other operating liabilities  | 6,302     |
|                                  | <hr/>     |
| Total liabilities held for sale  | \$ 13,141 |
|                                  | <hr/>     |



**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

3. Restatement of Previously Issued Financial Statements

The accompanying consolidated financial statements for the three and six months ended October 26, 2002 have been restated to recognize revenues upon customer receipt rather than at the time of shipment to reflect when risk of ownership is effectively transferred to the Company's customers. In addition, the Company has revised the accounting for two vendor contracts negotiated by a subsidiary of the Company during fiscal 2001. The Company has also reclassified costs associated with acquiring and preparing inventory for distribution from selling, general and administrative expenses to direct product costs for the three and six months ended October 26, 2002, to conform to the presentation adopted in the fourth quarter of fiscal 2003, and as previously discussed, the Company has reported the financial results from certain subsidiary companies as discontinued operations. As a result of the aforementioned, the Company has restated and reclassified its financial statements for the three months and six months ended October 26, 2002.

The following summarizes the restatements and reclassifications for the three and six months ended October 26, 2002 (in thousands of dollars):

| <u>Consolidated Statements of Income</u>                          | <u>Three Months<br/>Ended October 26,<br/>2002</u> | <u>Six Months<br/>Ended October 26,<br/>2002</u> |
|---|--|--|
| Revenues, previously reported                                     | \$ 348,891   | \$ 619,855                                       |
| Adjustments for:  |  |  |
| Revenue recognition   | (20,613)   | (14,347)   |
| Discontinued operations   | (25,119)   | (37,593)   |
| Revenues, restated  | 303,159  | 567,915  |
| Direct product costs, previously reported                         | 265,912  | 476,366  |
| Adjustments for:  |  |  |
| Revenue recognition   | (16,553)   | (10,196)   |
| Vendor contracts  | (55)   | (134)  |
| Reclassification of inventory related costs                       | 2,805  | 5,479  |
| Discontinued operations   | (16,012)   | (24,468)   |
| Direct product costs, restated                                    | 236,097  | 447,047  |
| Selling, general and administrative expenses, previously reported | 58,255   | 114,087  |
| Adjustments for:  |  |  |
| Revenue recognition   | (246)  | (235)  |
| Reclassification of inventory related costs                       | (2,805)  | (5,479)  |
| Discontinued operations   | (5,185)  | (8,737)  |
| Selling, general and administrative expenses, restated            | 50,019   | 99,636   |

**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

| <b>Consolidated Statements of Income, continued</b>                                   | <b>Three Months<br/>Ended October 26,<br/>2002</b> | <b>Six Months<br/>Ended October 26,<br/>2002</b> |
|---|--|--|
| Interest expense net, previously reported   | 223  | 606  |
| Adjustments for:  |  |  |
| Vendor contracts  | 7  | 15   |
| Discontinued operations   | (176)  | (369)  |
| Interest expense net, restated  | 54   | 252  |
| Income before income taxes and minority interest, previously reported                 | 24,501   | 28,796   |
| Adjustments for:  |  |  |
| Revenue recognition   | (3,814)  | (3,916)  |
| Vendor contracts  | 48   | 119  |
| Discontinued operations   | (3,746)  | (4,019)  |
| Income from continuing operations before income taxes and minority interest, restated | 16,989   | 20,980   |
| Income tax expense, previously reported   | (8,660)  | (10,435)   |
| Adjustments for:  |  |  |
| Revenue recognition   | 1,495  | 1,518  |
| Vendor contracts  | (17)   | (42)   |
| Discontinued operations   | 1,424  | 1,515  |
| Income tax expense-continuing operations, restated                                    | (5,758)  | (7,444)  |
| Income from discontinued operations, previously reported                              |  |  |
| Adjustments for:  |  |  |
| Income from operations of discontinued subsidiary companies                           | 3,746  | 4,019  |
| Income tax expense discontinued operations  | (1,424)  | (1,515)  |
| Income from discontinued operations, restated   | 2,322  | 2,504  |
| Net income, previously reported   | 16,033   | 18,727   |
| Adjustments for:  |  |  |
| Revenue recognition   | (2,319)  | (2,398)  |
| Vendor contracts  | 31   | 77   |
| Net income, restated  | \$ 13,745  | \$ 16,406  |
| Net income per share basic, previously reported                                       | \$ 0.61  | \$ 0.71  |
| Adjustments for:  |  |  |
| Revenue recognition   | (0.09)   | (0.09)   |
| Vendor contracts  |  |  |
| Net income per share basic, restated  | \$ 0.52  | \$ 0.62  |



**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

| <b>Consolidated Statements of Income, continued</b> | <b>Three Months<br/>Ended October 26,<br/>2002</b> | <b>Six Months<br/>Ended October 26,<br/>2002</b> |
|---|--|--|
| Net income per share diluted, previously reported   | \$ 0.61  | \$ 0.71  |
| Adjustments for:                                    |  |  |
| Revenue recognition                                 | (0.09)   | (0.09)   |
| Vendor contracts                                    |  |  |
| Net income per share diluted, restated              | <u>\$ 0.52</u>                                     | <u>\$ 0.62</u>                                   |

4. Stock Plans

The Company currently has employee stock option plans. Prior to fiscal 2004, the Company accounted for these plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related Interpretations. No stock-based employee compensation expense for stock plans was reflected in net income for fiscal years prior to fiscal 2004, as all stock granted under these plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. Effective May 4, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. The Company selected the prospective transition method, as defined in SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, an amendment to SFAS No. 123, *Accounting for Stock-Based Compensation*.

Under the prospective method, all options issued after May 4, 2003 will be accounted for utilizing the fair value provisions of SFAS No. 123. The pre-tax costs related to stock-based employee compensation included in the determination of net income for the three and six months ended November 1, 2003 was \$142,000 and \$256,000, respectively, which was less than that which would have been recognized if the fair value method had been applied to all awards since the original effective date of SFAS No. 123.



**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested options for each period presented (in thousands of dollars except per share data):

|   | Three Months Ended  |                                   | Six Months Ended    |                                   |
|---|---------------------|-----------------------------------|---------------------|-----------------------------------|
|   | November 1,<br>2003 | October 26,<br>2002<br>(Restated) | November 1,<br>2003 | October 26,<br>2002<br>(Restated) |
| Net income, as reported   | \$ 10,182           | \$ 13,745                         | \$ 11,892           | \$ 16,406                         |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects                                  | 91                  |                                   | 143                 |                                   |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (402)               | (436)                             | (676)               | (844)                             |
| <b>Pro forma net income</b>   | <b>\$ 9,871</b>     | <b>\$ 13,309</b>                  | <b>\$ 11,359</b>    | <b>\$ 15,562</b>                  |
| Net income per share:   |                     |                                   |                     |                                   |
| Reported - basic  | \$ 0.41             | \$ 0.52                           | \$ 0.48             | \$ 0.62                           |
| - diluted   | \$ 0.41             | \$ 0.52                           | \$ 0.47             | \$ 0.62                           |
| Pro forma - basic   | \$ 0.40             | \$ 0.51                           | \$ 0.45             | \$ 0.59                           |
| - diluted   | \$ 0.40             | \$ 0.51                           | \$ 0.45             | \$ 0.59                           |

5. Accounts Receivable

The table below presents information about the components of accounts receivable balances included in the Company's Consolidated Balance Sheets (in thousands of dollars):

|   | November 1, 2003  | May 3, 2003       |
|---|-------------------|-------------------|
| Trade accounts receivable                       | \$ 226,238        | \$ 226,263        |
| Less allowances for:                            |                   |                   |
| Gross profit impact of estimated future returns | (8,837)           | (12,759)          |
| Bankrupt customers                              |                   | (6,720)           |
| Doubtful accounts                               | (2,905)           | (4,790)           |
| <b>Accounts receivable, net</b>                 | <b>\$ 214,496</b> | <b>\$ 201,994</b> |

6. Acquired Rights

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The Company, principally in its proprietary products business, acquired rights to video licenses giving it the exclusive privilege to manufacture and distribute such products. The costs of acquired rights included advances paid to licensors and costs to create a master to be used for duplication. The acquired rights were amortized based upon the sales volume method over a period which was the lesser of the terms of the agreements or the products' estimated useful lives. On a regular basis, the Company performed analyses comparing the carrying value of its acquired rights with the expected future economic benefit of these assets. Based on such analyses, the Company adjusted, when necessary, the value of its acquired rights.

**Table of Contents**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

As discussed in Note 2 of Notes to Consolidated Financial Statements, the Company is selling certain subsidiary companies, and assets of these subsidiary companies included all amortized intangible assets of the Company. These intangible assets have been included in the Assets held for sale line item in the Company's Consolidated Balance Sheet as of November 1, 2003.

The following information relates to intangible assets subject to amortization (in thousands of dollars):

| Amortized<br>Intangible Assets | November 1, 2003            |                             | May 3, 2003                 |                             |
|--------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                                | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| License advances               |                             |                             | \$ 65,493                   | \$ 41,347                   |
| Masters                        |                             |                             | 33,794                      | 13,225                      |
| <b>Total</b>                   |                             |                             | <b>\$ 99,287</b>            | <b>\$ 54,572</b>            |

| Amortized<br>Intangible Assets | November 1, 2003 |   | May 3, 2003      |   |
|--------------------------------|------------------|---|------------------|---|
|                                | Net<br>Amount    | Weighted Avg.<br>Amortization<br>Period | Net<br>Amount    | Weighted Avg.<br>Amortization<br>Period |
| License advances               |                  | n/a                                     | \$ 24,146        | 100 mos.                                |
| Masters                        |                  | n/a                                     | 20,569           | 90 mos.                                 |
| <b>Total</b>                   |                  | <b>n/a</b>                              | <b>\$ 44,715</b> | <b>96 mos.</b>                          |

The following is a summary of aggregate amortization expense (in thousands of dollars):

| Period                              | Amount   |
|-------------------------------------|----------|
| Three months ended November 1, 2003 | \$ 5,195 |
| Three months ended October 26, 2002 | 7,140    |
| Six months ended November 1, 2003   | 9,417    |
| Six months ended October 26, 2002   | 11,573   |

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The following table summarizes estimated amortization expense based on the value of acquired rights as of November 1, 2003 (in thousands of dollars):

| <u>Fiscal Year</u> | <u>Amount</u> |
|--------------------|---------------|
| 2004               | \$ 9,417      |
| 2005               |               |
| 2006               |               |
| 2007               |               |
| 2008               |               |

The Company does not have any intangible assets, other than goodwill, which are not subject to amortization.

**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

7. New Accounting Pronouncements

In May 2003, SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued by the Financial Accounting Standards Board. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments based on whether such financial instruments embody an obligation of the issuer. The Company is evaluating the impact of this Statement and does not expect that SFAS No. 150 will have a significant impact on the consolidated financial position and results of operations of the Company.

8. Segment Information

The Company has operated in two business segments: Handleman Entertainment Resources ( H.E.R. ) is responsible for music category management and distribution operations, and NCE was responsible for the Company's proprietary operations, which included music and video product.

The accounting policies of the segments are the same as those described in Note 1, Accounting Policies, contained in the Company's Form 10-K for the year ended May 3, 2003. Segment data includes intersegment revenues, as well as a charge allocating corporate costs to the operating segments. The Company evaluates performance of its segments and allocates resources to them based on income before interest, income taxes and minority interest ( segment income ).

As described in Note 2 of Notes to Consolidated Financial Statements, the Company has reached an agreement to sell certain subsidiary companies, all of which had previously been reported in the NCE business segment. Fiscal 2004 amounts below represent all H.E.R. operations, as well as activity from remaining NCE operations other than from those companies which are held for sale. Fiscal 2003 amounts represent all H.E.R. operations, as well as results from Madacy Entertainment, which was sold in the third quarter of fiscal 2003, along with activity from remaining NCE operations other than from those companies which are held for sale.

The tables below present information about reported segments for the three months ended November 1, 2003 and October 26, 2002 (in thousands of dollars):

| Three Months Ended November 1, 2003:           | H.E.R.     | NCE       | Total      |
|--|------------|-----------|------------|
| Revenues, external customers                   | \$ 269,695 | \$ 55     | \$ 269,750 |
| Intersegment revenues                          |            |           |            |
| Segment income                                 | 11,807     | 74        | 11,881     |
| Capital expenditures                           | 4,919      | 7         | 4,926      |
| Three Months Ended October 26, 2002, Restated: | H.E.R.     | NCE       | Total      |
| Revenues, external customers                   | \$ 290,757 | \$ 21,199 | \$ 311,956 |
| Intersegment revenues                          |            | 8,942     | 8,942      |

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|                      |        |       |        |
|----------------------|--------|-------|--------|
| Segment income       | 15,327 | 1,378 | 16,705 |
| Capital expenditures | 4,901  | 107   | 5,008  |

**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of total segment revenues to consolidated revenues and total segment income to consolidated income from continuing operations before income taxes and minority interest, for the three months ended November 1, 2003 and October 26, 2002 is as follows (in thousands of dollars):

|   | November 1, 2003  | October 26, 2002<br>(Restated) |
|---|-------------------|--------------------------------|
| <b>Revenues</b>   |                   |                                |
| Total segment revenues  | \$ 269,750        | \$ 311,956                     |
| Corporate rental income   | 150               | 145                            |
| Elimination of intersegment revenues  |                   | (8,942)                        |
| <b>Consolidated revenues</b>  | <b>\$ 269,900</b> | <b>\$ 303,159</b>              |
| <b>Income From Continuing Operations Before Income Taxes and Minority Interest</b>              |                   |                                |
| Total segment income for reportable segments  | \$ 11,881         | \$ 16,705                      |
| Interest income   | 316               | 179                            |
| Interest expense  | (535)             | (233)                          |
| Unallocated corporate income  | 421               | 338                            |
| <b>Consolidated income from continuing operations before income taxes and minority interest</b> | <b>\$ 12,083</b>  | <b>\$ 16,989</b>               |

The tables below present information about reported segments as of and for the six months ended November 1, 2003 and October 26, 2002 (in thousands of dollars):

| <b>Six Months Ended November 1, 2003:</b>           | <b>H.E.R.</b> | <b>NCE</b> | <b>Total</b> |
|---|---------------|------------|--------------|
| Revenues, external customers                        | \$ 474,765    | \$ 129     | \$ 474,894   |
| Intersegment revenues                               |               |            |              |
| Segment income                                      | 13,328        | 67         | 13,395       |
| Total assets, excluding assets held for sale        | 531,039       | 7,441      | 538,480      |
| Capital expenditures                                | 6,684         | 32         | 6,716        |
| <b>Six Months Ended October 26, 2002, Restated:</b> | <b>H.E.R.</b> | <b>NCE</b> | <b>Total</b> |
| Revenues, external customers                        | \$ 542,854    | \$ 37,944  | \$ 580,798   |
| Intersegment revenues                               |               | 13,173     | 13,173       |
| Segment income                                      | 19,465        | 1,078      | 20,543       |
| Total assets  | 568,488       | 161,581    | 730,069      |
| Capital expenditures                                | 6,789         | 368        | 7,157        |





**Table of Contents**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of total segment revenues to consolidated revenues, total segment income to consolidated income from continuing operations before income taxes and minority interest, and total segment assets to consolidated assets as of and for the six months ended November 1, 2003 and October 26, 2002 is as follows (in thousands of dollars):

|   | November 1, 2003            | October 26, 2002<br>(Restated) |
|---|-----------------------------|--------------------------------|
|   | <u>                    </u> | <u>                    </u>    |
| <b><u>Revenues</u></b>  |                             |                                |
| Total segment revenues  | \$ 474,894                  | \$ 580,798                     |
| Corporate rental income   | 299                         | 290                            |
| Elimination of intersegment revenues  |                             | (13,173)                       |
|   | <u>                    </u> | <u>                    </u>    |
| Consolidated revenues   | \$ 475,193                  | \$ 567,915                     |
|   | <u>                    </u> | <u>                    </u>    |
| <b><u>Income from Continuing Operations Before Income Taxes and Minority Interest</u></b> |                             |                                |
| Total segment income for reportable segments  | \$ 13,395                   | \$ 20,543                      |
| Interest income   | 693                         | 334                            |
| Interest expense  | (686)                       | (586)                          |
| Unallocated corporate income  | 850                         | 689                            |
|   | <u>                    </u> | <u>                    </u>    |
| Consolidated income from continuing operations before income taxes and minority interest  | \$ 14,252                   | \$ 20,980                      |
|   | <u>                    </u> | <u>                    </u>    |
| <b><u>Assets</u></b>  |                             |                                |
| Total segment assets  | \$ 538,480                  | \$ 730,069                     |
| Assets held for sale  | 73,031                      |                                |
| Elimination of intercompany receivables and payables                                      | (25,128)                    | (72,436)                       |
|   | <u>                    </u> | <u>                    </u>    |
| Consolidated assets   | \$ 586,383                  | \$ 657,633                     |
|   | <u>                    </u> | <u>                    </u>    |

9. **Comprehensive Income**

Comprehensive income is net income plus certain other items recorded directly to shareholders' equity. Comprehensive income, net of tax was \$16.1 million for the six months ended November 1, 2003, compared to \$19.4 million, restated, for the six months ended October 26, 2002.

10. **Common Stock - Basic and Diluted Shares**

A reconciliation of the weighted average shares used in the calculation of basic and diluted shares is as follows (in thousands):

|  | <b>Three Months Ended</b> |                          | <b>Six Months Ended</b> |                          |
|--|---------------------------|--------------------------|-------------------------|--------------------------|
|  | <b>Nov. 1,<br/>2003</b>   | <b>Oct. 26,<br/>2002</b> | <b>Nov. 1,<br/>2003</b> | <b>Oct. 26,<br/>2002</b> |
| Weighted average shares during the period-basic                                | 24,742                    | 26,202                   | 25,034                  | 26,339                   |
| Additional shares from assumed exercise of stock options                       | 210                       | 15                       | 178                     | 22                       |
| Weighted average shares adjusted for assumed exercise of stock options-diluted | 24,952                    | 26,217                   | 25,212                  | 26,361                   |

**Table of Contents**

Item 2.

Handleman Company  
Management's Discussion and Analysis of  
Financial Condition and Results of Operations

The Company has operated in two business segments: Handleman Entertainment Resources ( H.E.R. ) and North Coast Entertainment ( NCE ). H.E.R. consists of music category management and distribution operations principally in North America and the United Kingdom ( UK ). NCE encompassed the Company's proprietary operations, which included music and video product.

During the second quarter of fiscal 2004, which ended November 1, 2003, the Company committed to a plan, and then reached an agreement, to sell certain of its subsidiary companies (generally known as Anchor Bay Entertainment) within its NCE business segment. In accordance with accounting standards, the financial results of these subsidiary companies held for sale were reported as discontinued operations in the Company's Consolidated Statements of Income for all periods presented. As a result, income from continuing operations for the second quarter and six-month periods of fiscal 2004 substantially included only H.E.R. operations, while the comparable periods for the second quarter of fiscal 2003, which ended October 26, 2002, predominately included all H.E.R. operations, as well as operating activities from NCE, mainly those of the Madacy Entertainment business unit, which was sold during the third fiscal quarter of last year.

Net income for the second quarter of fiscal 2004 was \$10.2 million or \$.41 per diluted share, compared to \$13.7 million or \$.52 per diluted share for the second quarter of fiscal 2003. Net income for the second quarter of this year included \$1.7 million or \$0.07 per diluted share from discontinued operations, including the recognition of a \$1.1 million or \$0.04 per diluted share after-tax impairment charge on the sale discussed above. Net income for the second quarter of last year included \$2.3 million or \$0.09 per diluted share from discontinued operations. Also, net income in the second quarter of last year included \$1.0 million or \$0.04 per diluted share from the Madacy Entertainment business unit, which, as mentioned above, was sold during the third fiscal quarter of last year.

Net income for the first six months of this year was \$11.9 million or \$.47 per diluted share, compared to \$16.4 million or \$.62 per diluted share for the comparable six-month period of last year. Net income for the six-month periods this year and last year included income from discontinued operations of \$2.6 million or \$0.10 per diluted share and \$2.5 million or \$0.09 per diluted share, respectively. Additionally, net income in the first six months of fiscal 2003 included \$1.1 million or \$0.04 per diluted share from the Madacy Entertainment business unit, which was sold during the third fiscal quarter of last year.

Unless otherwise noted, the following discussion relates only to results from continuing operations.

Revenues for the second quarter of fiscal 2004 decreased 11% to \$269.9 million from \$303.2 million for the second quarter of fiscal 2003. Approximately 35% of the decrease in revenues for the second quarter of fiscal 2004 resulted from the absence of Madacy Entertainment revenues, due to the sale of that business unit in the third quarter of fiscal 2003. The remaining decrease in revenues resulted from lower revenues at H.E.R. Income from continuing operations for the second quarter of fiscal 2004 was \$8.5 million or \$.34 per diluted share, compared to \$11.4 million or \$.43 per diluted share for the second quarter of fiscal 2003. The decrease was due, in part, to the absence of Madacy Entertainment, which contributed \$0.04 per diluted share in the second quarter of last year.

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Revenues for the first six months of fiscal 2004 were \$475.2 million, a 16% decrease from revenues of \$567.9 million for the first six months of fiscal 2003. Income from continuing operations for the six

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**Table of Contents**

months ended November 1, 2003 was \$9.3 million or \$.37 per diluted share, compared to \$13.9 million or \$.53 per diluted share for the comparable six-month period of last year. The absence of Madacy Entertainment from fiscal 2004 results accounted for 23% of this decrease in revenues, with the remaining decrease in revenues mainly due to lower H.E.R. revenues. Madacy Entertainment contributed \$0.04 per diluted share to earnings for the six-month period ended October 26, 2002.

H.E.R. revenues were \$269.7 million for the second quarter of fiscal 2004, compared to \$290.8 million for the second quarter of fiscal 2003, a decrease of 7%. The decrease in H.E.R. revenues for the second quarter of this year was primarily due to lower net sales within the H.E.R. United States ( U.S. ) operation; fewer stores serviced accounted for \$28.8 million of decreased revenues. Net sales in the U.S. were further negatively impacted by lower music retail sales in certain customers' stores, and a delay, compared to the prior year, in building seasonal inventory levels for the holiday season by some of the Company's customers. The decline in H.E.R. U.S. revenues was partially offset by higher revenues in the UK and Canadian operations of \$22.1 million and \$6.9 million, respectively.

H.E.R. revenues for the first six months of this year were \$474.8 million, a decrease of 13% from revenues of \$542.9 million for the first six months of last year. For the six-month period, this year versus last year, the H.E.R. U.S. operation was affected by fewer stores serviced, which accounted for \$48.5 million in decreased revenues, and again, by lower music retail sales in certain customers' stores, and the delay of seasonal inventory buildup by some of the Company's customers. The decline in H.E.R. U.S. revenues was offset, in part, by revenue increases in the UK and Canada for the first six months of fiscal 2004 of \$23.2 million and \$8.0 million, respectively, compared to the first six months of fiscal 2003.

Direct product costs as a percentage of revenues was 79.5% for the second quarter ended November 1, 2003, compared to 77.9% for the second quarter ended October 26, 2002. This increase in direct product costs as a percentage of revenues, for the second quarter of this fiscal year, was primarily due to the absence of Madacy Entertainment in fiscal 2004, which historically operated at lower direct product costs as a percentage of revenues than the Company's other operating units. Direct product costs for the second quarters ended November 1, 2003 and October 26, 2002 included costs associated with acquiring and preparing inventory for distribution in the amounts of \$2.5 million and \$2.8 million, respectively. Consolidated direct product costs as a percentage of revenues was 79.0% for the first six months of fiscal 2004, compared to 78.7% for the first six months of fiscal 2003. Direct product costs for the first six months of fiscal 2004 and 2003 included costs associated with acquiring and preparing inventory for distribution of \$4.9 million and \$5.5 million, respectively.

Selling, general and administrative ( SG&A ) expenses were \$43.1 million or 16.0% of revenues for the second quarter of fiscal 2004, compared to \$50.0 million or 16.5% of revenues for the second quarter of fiscal 2003. The lower level of SG&A expenses in the second quarter of this year, both in dollars and as a percentage of revenues, was mainly due to the absence of Madacy Entertainment in fiscal 2004; Madacy Entertainment historically incurred higher SG&A expenses, as a percentage of revenues, than the Company's other operating units. SG&A expenses for the first six months of this year were \$85.3 million or 18.0% of revenues, compared to \$99.6 million or 17.5% of revenues for the first six months of last year. The lower SG&A expenses for the first six months of this fiscal year were, again, mainly attributable to the absence of Madacy Entertainment. However, the increase in SG&A expenses as a percentage of revenues, over the comparable six-month period last year, was primarily due to the Company's fixed cost structure and lower year-to-date revenues in fiscal 2004 versus those in fiscal 2003.

Income before interest, income taxes and minority interest ( operating income ) for the second quarter of fiscal 2004 was \$12.3 million, compared to \$17.0 million for the second quarter of fiscal

**Table of Contents**

2003. Operating income for the first six months of this fiscal year was \$14.2 million, compared to \$21.2 million for the first six months of last fiscal year. Approximately 45% and 39%, respectively, of the decline in operating income was attributable to the absence of Madacy Entertainment in the year-over-year three-month and six-month periods; with the remaining decrease resulting from lower operating income at H.E.R.

H.E.R. operating income for the second quarter of this year was \$11.8 million, compared to \$15.3 million for the second quarter of last year, a decrease of 23%. The lower H.E.R. operating income was due to a decrease in its U.S. operating income, compared to the same period last year, primarily due to the lower sales volume, as previously discussed. The lower U.S. operating income was partially offset by an improvement in operating income within the H.E.R. UK operation, chiefly due to lower direct product costs as a percentage of revenues resulting from achieving more favorable vendor terms, and a reduction in the operating loss of \$2.1 million at the Company's e-commerce subsidiary due to the refocusing of that subsidiary, in the third quarter of last year, to better align its operations with the Company's core competencies of distribution and category management. H.E.R. operating income for the first six months of fiscal 2004 was \$13.3 million, compared to \$19.5 million for the first six months of fiscal 2003.

Interest expense, net for the second quarter of fiscal 2004 was \$0.2 million, compared to \$0.1 million for the second quarter of fiscal 2003. During the second quarter of this fiscal year, the Company prepaid its outstanding debt under a senior note agreement with a group of insurance companies, in the amount of \$7.1 million (\$3.5 million was scheduled to mature in February 2004, with the remaining \$3.6 million scheduled to mature in February 2005). As a result of the early payment, the Company incurred a pre-payment cost of \$474,000, which is included in interest expense, net. The Company would have incurred interest expense of \$598,000 had it held the senior note to maturity. Interest expense, net for the six months ended November 1, 2003 approximated break even, compared to \$0.3 million for the six-month period ended October 26, 2002.

The following table summarizes the Company's cash obligations and commitments as of November 1, 2003, along with their expected effect on its liquidity and cash flows in future periods (in thousands of dollars):

|   | Total            | Less than       |                  |                 | After 5<br>Years |
|---|------------------|-----------------|------------------|-----------------|------------------|
|   |                  | 1 Year          | 1-3 Years        | 4-5 Years       |                  |
| Other long-term obligations                               | \$ 4,725         | \$ 1,737        | \$ 2,988         | \$              | \$               |
| Operating leases and other commitments                    | 21,864           | 4,814           | 10,330           | 2,057           | 4,663            |
| Less: operating sub-leases                                | (733)            | (194)           | (539)            |                 |                  |
| Outstanding letters of credit                             | 3,361            | 3,361           |                  |                 |                  |
| <b>Total contractual cash obligations and commitments</b> | <b>\$ 29,217</b> | <b>\$ 9,718</b> | <b>\$ 12,779</b> | <b>\$ 2,057</b> | <b>\$ 4,663</b>  |

The above table includes obligations of the subsidiary companies held for sale totaling \$0.8 million as of November 1, 2003.

The effective income tax rate for the second quarter of fiscal 2004 was 29.4% compared to 33.9% for the second quarter of fiscal 2003. The lower tax rate this year was primarily due to benefits recognized from certain operating losses the Company incurred during the first quarter of this year. The effective income tax rate for the first six months of fiscal 2004 was 34.8% compared to 35.5% for the same period last year.



**Table of Contents**

During the second quarter of fiscal 2004, the Company repurchased 452,100 shares of its common stock at an average price of \$17.11 per share. As of November 1, 2003, the Company had repurchased 1.6 million shares, or 31% of the shares authorized by its Board of Directors under a 20% share repurchase program. The Company plans to use a portion of the proceeds from the sale of certain NCE subsidiary companies to make further purchases under the current share repurchase authorization.

As mentioned earlier, during the second quarter of this year, the Company reached an agreement to sell certain subsidiary companies within its NCE business segment. The sale was completed on December 11, 2003, and generated approximately \$60,000,000 in cash. As a result of the sale, the Company recorded a pre-tax impairment charge related to the transaction in the amount of \$0.7 million in the second quarter of this fiscal year. The Company also recorded \$0.4 million of income tax expense related to the transaction due to book versus tax basis differences. The after-tax loss on the sale totaled \$1.1 million or \$0.04 per diluted share, which was included in Income from discontinued operations in the Company's Consolidated Statements of Income. Additionally, in accordance with accounting standards, the assets and liabilities of these subsidiary companies were classified as held for sale on the Company's Consolidated Balance Sheets as of November 1, 2003.

Accounts receivable at November 1, 2003 was \$214.5 million, compared to \$202.0 million at May 3, 2003. The increase reflects the higher sales volume in the second quarter of this year versus the fourth quarter of last year.

Merchandise inventories at November 1, 2003 was \$176.6 million, compared to \$120.0 million at May 3, 2003. This increase was primarily due to higher inventory purchases in preparation for the upcoming holiday season.

Intangible assets, net are zero as of November 1, 2003, compared to \$44.7 million at May 3, 2003. The intangible assets comprising the balance at May 3, 2003, were related to the subsidiary companies which are held for sale, and accordingly, are included in Assets held for sale as of November 1, 2003.

Accounts payable increased to \$227.8 million at November 1, 2003 from \$159.7 million at May 3, 2003. The increase in accounts payable chiefly resulted from higher inventory purchases in the second quarter of fiscal 2004, compared to the fourth quarter of fiscal 2003, as mentioned above.

Accrued and other liabilities decreased to \$30.4 million at November 1, 2003, from \$40.6 million at May 3, 2003. The decrease was mainly attributable to decreases in accrued compensation related items and the reclassification of accrued royalties to Liabilities held for sale.

The Company has an unsecured \$170 million line of credit arranged with a consortium of banks. During the second quarter of this year, the expiration date of this agreement was extended one year to August 2006. Management believes that the revolving credit agreement, along with cash provided from operations, will provide sufficient liquidity to fund the Company's day-to-day operations, including seasonal increases in working capital, as well as repurchases of common stock under the Company's stock repurchase program. The Company had no borrowings against its line of credit at November 1, 2003 or May 3, 2003. As discussed above, during the second quarter of this year, the Company prepaid its outstanding debt under a senior note agreement with a group of insurance companies, in the amount of \$7.1 million.



**Table of Contents**

On September 10, 2003, the Company announced the reinstatement of a quarterly cash dividend. As a result, the initial dividend of \$0.07 per share, totaling \$1.7 million, was paid on October 10, 2003 to shareholders of record at the close of business on September 24, 2003.

Cash provided from operating activities for the first six months of fiscal 2004 was \$0.5 million, compared to cash provided from operating activities of \$15.9 million for the comparable six-month period of last year. The decrease in cash flows from operating activities was primarily related to a decrease in net income, lower levels of non-cash charges (principally depreciation expense and recoupment/amortization of acquired rights), and an increased investment in accounts receivable, partially offset by incremental financing from accounts payable. Net cash used by investing activities decreased to \$13.0 million for the six months ended November 1, 2003, from cash used by investing activities of \$18.3 million for the six months ended October 26, 2002. The reduction in cash used by investing activities was primarily attributable to the Company's investments in subsidiary companies during the first half of last fiscal year of \$5.8 million, and a favorable year-over-year change in acquired rights expenditures of \$3.5 million, partially offset by a reduction in year-over-year proceeds from the disposition of properties and equipment of \$4.5 million. Cash used by financing activities was \$23.0 million for the first six months of this fiscal year, compared to cash used by financing activities of \$11.0 million for the first six months of last fiscal year. The increase in cash used by financing activities was primarily due to repurchases of the Company's common stock.

Reference should be made to Notes 4 and 7 of the Notes to Consolidated Financial Statements, in this Form 10-Q, for new accounting pronouncements adopted in fiscal 2004, and those currently being evaluated by the Company.

The Company expects sales from continuing operations for its third and fourth quarters of this fiscal year to be comparable to, or slightly greater than, sales from continuing operations for its third and fourth quarters of last year, which were \$711.0 million. The sales forecast this year is based on the Company servicing the same number of customers' stores it currently does. As a result, the Company expects fully diluted earnings per share from continuing operations in the second half of this fiscal year to be equal to, or slightly greater than, the fully diluted earnings per share from continuing operations of \$1.03 earned in the second half of last fiscal year. Accordingly, the Company expects fully diluted net income per share for the fiscal year ending May 1, 2004 to fall within the range of \$1.50 to \$1.55 per share, of which fully diluted earnings per share from continuing operations will fall within the range of \$1.40 to \$1.45 per share.

\* \* \* \* \*

This document contains forward-looking statements, which are not historical facts and involve risk and uncertainties. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements, including without limitation, conditions in the music industry, business with a key customer following its emergence from Chapter 11 proceedings, the conclusion of the sale of certain subsidiary companies, the ability to enter into profitable agreements with customers in the new businesses outlined in the Company's strategic growth plan, securing funding or providing sufficient cash required to build and grow new businesses, customer requirements, continuation of satisfactory relationships with existing customers and suppliers, effects of electronic commerce, effects of music product piracy, relationships with the Company's lenders, pricing and competitive pressures, the occurrence of catastrophic events or acts of terrorism, certain global and regional economic conditions, and other factors detailed from time to time in the Company's filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this document. Additional information that could cause actual results to differ materially from any forward-looking statements may be contained in the Company's Annual Report on Form 10-K.

**Table of Contents**

Item 4.

**CONTROLS AND PROCEDURES**

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) of the Securities Exchange Act of 1934 (the Act) as of November 1, 2003 was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures, as currently in effect, are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the second fiscal quarter ended November 1, 2003, that have materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company intends to continually review and evaluate the design and effectiveness of its disclosure controls and procedures and to improve its controls and procedures over time and to correct any deficiencies that it may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While the Company believes the present design of its disclosure controls and procedures is effective to achieve its goal, future events affecting its business may cause the Company to modify its disclosure controls and procedures.

**Table of Contents**

PART II - OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders

An Annual Meeting of Shareholders of Handleman Company was held on October 14, 2003. One item was voted on at the Annual Meeting, the election of directors. The following individuals were elected as directors of the Company: James B. Nicholson, 22,067,715 votes for, 321,945 votes withheld; Lloyd E. Reuss, 22,069,412 votes for, 320,248 votes withheld; and Stephen Strome, 21,638,383 votes for, 751,277 votes withheld.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 31.1 - Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 - Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32 - Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  
Furnished to the Securities and Exchange Commission

(b) Reports on Form 8-K

During the quarter ended November 1, 2003, the Company filed the following Current Reports on Form 8-K:

(1) On August 4, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting Registrant's application for an extension to file its Form 10-K for the fiscal year ended May 3, 2003.

(2) On August 20, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting Registrant's filing of its Form 10-K for the fiscal year ended May 3, 2003.

(3) On September 5, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting Registrant's financial results for the first quarter ended August 2, 2003.

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(4) On September 12, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting Registrant's initiation of a quarterly cash dividend.

**Table of Contents**

SIGNATURES: Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HANDLEMAN COMPANY

DATE: December 16, 2003

BY:

/s/ Stephen Strome

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STEPHEN STROME  
Chairman of the Board and

Chief Executive Officer

DATE: December 16, 2003

BY:

/s/ Thomas C. Braum, Jr.

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THOMAS C. BRAUM, JR.  
Senior Vice President and

Chief Financial Officer  
(Principal Financial Officer)